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No. 06-937

In the Supreme Court of the United States

QUANTA COMPUTER, INC., QUANTA COMPUTER USA, INC., Q-LITY COMPUTER, INC., COMPAL ELECTRONICS, INC., BIZCOM ELECTRONICS, INC., SCEPTRE TECHNOLOGIES, INC., FIRST INTERNATIONAL COMPUTER, INC. AND FIRST INTERNATIONAL COMPUTER OF AMERICA, INC.,

PETITIONERS,

v.

LG ELECTRONICS, INC.,

RESPONDENT.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF OF PETITIONERS

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ARGUMENT

Respondent says Petitioners have conceded that licenses may contain conditions, and pretends that is all this case involves. That is sleight of hand. Manufacturing licenses may have conditions on what sales are authorized, but an authorized sale exhausts the patent and ends the patentee's right under the patent laws to restrict the use or resale of the sold goods. (Whether the patentee could still enforce a *contractual* promise by the purchaser, under contract law, is a different question not presented here.) Respondent contends that its theoretical ability to place limits on Intel's license to *make and sell* (which it did not exercise) is the same thing as a right to limit Petitioners' *use* of goods that they have duly purchased. It is not the same, and once that mistake is understood Respondent's arguments fall apart.

1. The petition explained that the Federal Circuit precedent allowing patent owners to sell goods subject to use or resale "conditions," starting in *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700 (Fed. Cir. 1992), conflicts with this Court's cases and is the subject of widespread scholarly condemnation. The Federal Circuit has essentially revived the old rule of *Henry v. A.B. Dick Co.*, 224 U.S. 1 (1912), that a purchaser's right to use a patented good is a matter of implied license rather than patent exhaustion ("nothing more nor less than an unrestricted license presumed from an unconditional sale," *id.* at 24) and therefore can be limited or defeated if the patent owner specifies "conditions" or restrictions on the purchaser's "license" to use or resell the goods it has purchased. That has not been the law since this Court expressly overruled *A.B. Dick* in *Motion Picture Patents Co. v. Universal Film Mfg. Co.*, 243 U.S. 502 (1917).

The brief in opposition does not even try to defend the *Mallinckrodt* principle. Instead, it suggests that cases like *Mallinckrodt* involve "patentee sales" whereas this is a "licensee sale" case. Opp. 18-19 n.9. It argues that this Court has held (and that Petitioners have conceded, in the petition and below) that a patent owner may impose whatever conditions or limitations it likes on a license

granted to a manufacturing licensee. Respondent completely misses the point of this Court's cases, and of Petitioners' argument.

Respondent relies heavily on *General Talking Pictures Corp. v. Western Electric Co.*, 304 U.S. 175 (1938), which holds that exhaustion is triggered only by an *authorized* sale. Just as the patentee may choose which customers it wants to sell to, it may authorize its licensee to sell only to some customers. In *General Talking Pictures* this Court held that a customer who purchased goods from a licensee *knowing that the licensee lacked authority to make that sale* could be sued for infringement. This Court reasoned that the authorized sale necessary to trigger exhaustion never happened, and therefore the customer was not "'a purchaser in the ordinary channels of trade.'" *Id.* at 180-81.

That principle does not apply here because it is undisputed that Intel had authority to make these sales. Respondent contends that *General Talking Pictures* stands for a broader principle: that patentees may authorize a licensee to make sales *subject to conditions on the purchaser's use or resale of the good*, and then sue the purchaser for infringement if it violates those conditions. In other words, it asserts that a patentee can insert language into manufacturing licenses specifying that an authorized sale by the licensee will not have its ordinary legal effect (exhaustion). That misunderstands *General Talking Pictures* and the petition's discussion of the difference between licenses and sales. A license can have conditions, but a sale cannot. A sale exhausts the patent. A patent owner can place conditions on a licensee's right to make or sell, but it cannot authorize the licensee to sell an article *without exhausting the patent monopoly in that article.*

Respondent's position appears to be that even if a sale by the patentee itself exhausts the patent and nullifies any "conditions," a sale by *a licensee* need not have that effect, if the patentee has otherwise specified in the license. That proposed distinction is inconsistent with this Court's cases, which have always recognized that "in the essential nature

of things, when the patentee, *or the person having his rights*, sells a machine or instrument whose sole value is in its use, he receives the consideration for its use and he parts with the right to restrict that use." *Adams v. Burke*, 84 U.S. 453, 456 (1873) (emphasis added). *Adams* involved a sale by a licensee/assignee rather than the patentee. So did *United States v. Univis Lens Co.*, 316 U.S. 241, 244 (1942). Respondent's proposed distinction is also absurd. Licensing someone else to exercise the patentee's rights cannot expand those rights. The patentee cannot do indirectly what this Court's cases prohibit it from doing directly. Otherwise every patentee would erect a shell entity to "license" its patents, and then let that shell make the sales.

Respondent also points to *Mitchell v. Hawley*, 83 U.S. 544 (1873). The language in *Hawley* that Respondent relies on represented one strand in this Court's early case law—the line of reasoning that ultimately produced *A.B. Dick*, but was rejected in *Motion Picture Patents*. Pet. 12-15. *Hawley* was never overruled, but that is because its actual holding is consistent with this Court's later cases (and with Petitioners' position here). The licensee was given the right "to make and use 'and to license to others the right to use the said machines,'" but that license expressly provided that the licensee "'shall not, in any way or form, dispose of, sell, or grant any license to use the said machines beyond the expiration' of the original term" of the patent. *Hawley*, 83 U.S. at 548-49. Since the licensee in *Hawley* had the right to make and use the patented invention, and to license others to use it (subject to conditions), but "never had any power to sell a machine so as to withdraw it indefinitely from the operation of the franchise secured by the patent," *id.* at 551, its sale of the machines to Mitchell was unauthorized by the license and therefore did not trigger exhaustion. *Hawley* is an early application of the *General Talking Pictures* principle. It does not support Respondent's claim that an authorized sale can be burdened with "conditions."

There is an important distinction between licenses and sales. But there is no distinction between "patentee sales"

and "licensee sales" for exhaustion purposes. Certainly the Federal Circuit has not drawn such a distinction; it said this case is controlled by *Mallinckrodt* and its other precedents permitting sales to be "conditional" whoever the seller is.

2. Respondent's suggestion that this case involves only the adequacy of particular license language fails for the same reasons. No clever drafting can achieve a "conditional sale," because as a matter of law "one who buys patented articles of manufacture from one authorized to sell them becomes possessed of an absolute property in such articles, unrestricted in time or place." *Keeler v. Standard Folding Bed Co.*, 157 U.S. 659, 666 (1895); *see Adams*, 84 U.S. at 456.

Respondent might have achieved something like what it seeks here by procuring an actual contractual agreement from Petitioners that they would not use chips purchased from Intel without obtaining a separate license, and then enforcing that promise via ordinary contract law rather than an infringement suit. *Keeler*, 157 U.S. at 666 ("Whether a patentee may protect himself ... by special contracts brought home to the purchasers is not a question before us," but "[i]t is, however, obvious that such a question would arise as a question of contract" rather than patent infringement.). It might have specified that Intel was not authorized to sell its chips unless the customer signed such a contract—or that Intel could not *sell* its chips at all, but (as in *Hawley*) could only rent them out with a license to use.

But particular legal forms have particular consequences, and holding parties to those consequences does not defeat freedom of contract but enables it. Under this Court's cases, *selling* patented goods frees them forever from the patent monopoly. That rule reduces transaction costs by allowing purchasers to trust they may own and use goods without fear of infringing the device or method patents covering the only reasonable use. "The inconvenience and annoyance to the public that an opposite conclusion would occasion are too obvious to require illustration." *Id.* at 666-67. *Amici* Dell, Inc. *et al.* debunk Respondent's suggestion that the Federal Circuit's rule will produce negotiations

fairly allocating the value of the patent up and down the distribution chain. And that rule does not just give patent owners the same contractual freedom as other property holders. Patentees are as free to use contract law as anyone; the Federal Circuit has granted them a unique power to impose restraints on use or alienation running with chattels and enforce them with the full weight of patent law.

3. Respondent's waiver arguments are incorrect for the same reason. Indeed, it does not genuinely contend that the petition is inconsistent with Petitioners' arguments below; the brief in opposition argues throughout (incorrectly) that Petitioners' arguments below *and in the petition* have accepted Respondent's distinction between "licensee sales" and "patentee sales." Respondent just misunderstands the point of those arguments, below and before this Court.

Respondent quotes Petitioners' briefs arguing that "'the scope of the license granted to the direct *licensee* . . . sets the parameters for permissible conduct by subsequent purchasers from that licensee'" and that "'[i]f LGE had wished to legally restrict Intel's customers' use of the licensed products, it could, and indeed should, have placed the same limitations on the rights it granted to Intel.'" Opp. 17 (quoting Defts' Response to Questions 8-9 (Dec. 4, 2002) ("RQ")). There is no inconsistency. Petitioners' argument below, as in the petition, was that exhaustion applies because "LGE has not claimed that Intel breached the license agreement by selling to [Petitioners]." Reh'g Pet. 8. In other words, because the sales were authorized by Intel's license this case is controlled by *Univis Lens* rather than *Hawley* or *General Talking Pictures*. *See, e.g.*, RQ at 3 ("When an authorized sale is made pursuant to a license, the patent exhaustion doctrine is invoked, and a patentee's rights terminated."); *id.* ("'[The licensee's] conceded right to sell the chips deprives [the patent holder] of any claim of infringement [against the licensee's customers].'").

Respondent also quotes snippets from Petitioners' briefs below arguing that exhaustion applies because these sales were "unrestricted or unconditional." Petitioners framed

their argument below, as they must, in terms of the settled circuit precedent that exhaustion requires an "unconditional" sale. But the substance of their argument, there as here, was that a sale is "unconditional" in the relevant sense, and triggers exhaustion, if the seller had authority to sell. Petitioners also argued that under prior Federal Circuit cases any sale "condition" is enforceable only if it "rises to the level of an enforceable contractual right," which is clearly not true here. Reh'g Pet. 9. Petitioners did not make the unnecessary alternative point, made in the petition, that under this Court's precedents a contractual restriction on the purchaser would, in any event, be enforceable *only under contract law*, not infringement suits. But this Court has consistently held that so long as a *claim* was raised below, parties are entitled to make new *arguments* in support of that claim.[1] Petitioners argued that patent exhaustion applies, relying on the same cases from this Court cited in the petition and on prior Federal Circuit cases indicating that the *Mallinckrodt* holding should not apply here even on its own terms. They were not required to argue in the alternative that exhaustion should also apply because *Mallinckrodt* should be overruled, particularly when that would have been utterly futile in light of circuit precedent.[2]

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[1] The "traditional rule is that 'once a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below.'" *Lebron v. Nat'l R.R. Passenger Corp.*, 513 U.S. 374, 379 (1995) (quoting *Yee v. City of Escondido*, 503 U.S. 519, 534 (1992)); *see also PGA Tour, Inc. v. Martin*, 532 U.S. 661, 678 n.27 (2001); Robert L. Stern et al., *Supreme Court Practice* § 6.25, at 421 (8th ed. 2002).

[2] *See, e.g., Grosso v. United States*, 390 U.S. 62, 70-71 (1968) (failure to raise issue excused because of futility in light of prevailing law); *Leary v. United States*, 395 U.S. 6, 27-29 (1969) (same). The Federal Circuit has declined opportunities to reconsider *Mallinckrodt en banc*. *See, e.g., Hewlett-Packard Co. v. Repeat-O-Type Stencil Mfg. Corp.*, 123 F.3d 1445 (Fed. Cir. 1997) (reh'g *en banc* denied Oct. 14, 1997); *Jazz Photo Corp. v. ITC*, 264 F.3d 1094 (Fed. Cir. 2001) (reh'g *en banc* denied Nov. 9, 2001). And in any event a party does not waive anything by failing to assert it in a rehearing petition. Fed. R. App. P. 40(a); Sup. Ct. R. 13(3).

4. Respondent's brief discussion of the cases from other circuits also suffers from its pervasive misunderstanding of the governing principles. The cases cited at Pet. 25-26 show that prior to the Federal Circuit's creation "'restrictions on the right to sell imposed on manufacturing licensees were enforceable,'" Opp. 13 (quoting Pet. 25), but restrictions on a *purchaser*'s right to use or resell were not. The Federal Circuit's analysis *is not* consistent with those principles, as explained above. Respondent is correct that any conflict is no longer significant after the Federal Circuit's creation, but that just proves that there is no reason to delay review.

5. Respondent argues that *Univis Lens* is just an antitrust case and *Motion Picture Patents* is just a patent misuse case. This is the same error that the Federal Circuit made in *Mallinckrodt*, and that leading commentators have condemned. Pet. 26. *Motion Picture Patents* did not "simply g[ive] rise to the *patent misuse* bar on certain tying arrangements," Opp. 20; it expressly overruled *A.B. Dick* and held that *any* notice restrictions on the use of sold goods are unenforceable because of patent exhaustion, by analogy to the first sale doctrine in copyright. (Respondent's suggestion that statutory differences between the patent and copyright statutes make that analogy inapt is inconsistent with *Motion Picture Patents*.)

Respondent suggests that *Univis Lens* holds only that restrictions are exhausted by an authorized sale if they are also invalid under the antitrust laws. Opp. 21. This Court's holding was that "upon familiar principles the authorized sale of an article which is capable of use only in practicing the patent is a relinquishment of the patent monopoly with respect to the article sold," and it "exhausts the monopoly in that article and the patentee may not thereafter, by virtue of his patent, control the use or disposition of the article." 316 U.S. at 249-50. Like the Federal Circuit, Respondent "is merely saying in a peculiar manner that it does not like the Supreme Court's reasoning and thinks that the Court should have held something else—that it should have reached its end result by a different conceptual route." Richard H.

Stern, *The Unobserved Demise of the Exhaustion Doctrine in U.S. Patent Law: Mallinckrodt v. Medipart*, 15 Eur. Intell. Prop. Rev. 460, 465 (1993). Respondent and the Federal Circuit dislike the exhaustion doctrine and believe patentees should be able to impose restrictions on the use or resale of sold goods, subject only to antitrust laws. That was the *A.B. Dick* rule, rejected by this Court 90 years ago.

Respondent's attempt to distinguish *Univis Lens* on the ground that the facts there "confirmed, rather than negated, a 'license'," Opp. 21, is boldly illogical. The patentee in *Univis Lens* did indeed have license agreements with the purchasers, and those license agreements imposed certain explicit conditions and limitations on the purchasers' use of the purchased goods. This Court's holding was that those conditions and limitations drew no support from the patent, because the authorized sale of the lens blanks exhausted the patentee's rights despite what the licenses said. In other words, this Court held that exhaustion nullified what was indisputably the contractual intent of the parties. The only difference here is that the parties' contractual intent to defeat exhaustion is far less clear than in *Univis Lens*.

6. Respondent relies on other inapposite principles. Its elaborate discussion of the terms of the Intel-LGE agreements can establish, at most, that they do not convey an "implied license" to Petitioners—and is thus irrelevant. The relevant (and undisputed) point is that Intel's sales to Petitioners were authorized and not a breach of its license.

Respondent implies that it matters that Intel's chips do not themselves infringe the subject patents. Neither did the lens blanks in *Univis Lens*. Nonetheless this Court held that sale of an article exhausts any patents covering its only reasonable use. Respondent's suggestion (Opp. 11 n.7) that these chips have non-infringing uses is inconsistent with the district court's findings, undisturbed by the Federal Circuit.

Respondent invokes the rule that a patentee may sue both a manufacturer and its customers for infringement, so long as it does not recover duplicative damages. Opp. 24-25. The point of the exhaustion doctrine is that, as a matter of

law, the patentee "in the act of sale receive[s] all the royalty or consideration which he claims for the use of his invention in that particular machine or instrument." *Adams*, 84 U.S. at 456. Any royalties the patentee attempts to collect after that are "duplicative" and an improper attempt to expand the patent monopoly, by definition. Respondent's protest that the price it negotiated from Intel is not the full value of the patent (Opp. 27-28) is quibbling with its own bargain.

Respondent also asserts that the Federal Circuit held, or that Petitioners have conceded, that all of the sales here occurred after the notices were received. That is incorrect, although Petitioners will accept Respondent's concession that it now will not seek infringement damages relating to any pre-notice purchases. Petitioners' point was not that there is any distinction between the pre-notice and post-notice sales (the notice is a legal nullity), but simply that the appearance of the notice out of the blue, after Petitioners had been buying from Intel for years, disproves the idea that the prices they paid reflected this purported limitation.

Regardless, Respondent concedes that the Federal Circuit's reasoning cannot be limited to buyers with notice. Opp. 19-20. In its view, a patentee can license someone to make and sell the patented good in the marketplace but, by putting a disclaimer in that non-public license agreement that no "implied license" for purchasers is intended, reserve the right to sue unwitting purchasers for infringement even if they had no notice of the limitation. As *amicus* Minebea Co. points out, this decision is already interpreted that way.

7. Respondent's arguments about method patents (Opp. 23-24 n.11) are inconsistent with *Univis Lens*. Pet. 21. One of the patents held to be exhausted in *Univis Lens* was a pure method patent. The question presented clearly encompasses this issue, and it independently merits review. If sale of an article exhausted device patents but not method patents covering the only reasonable use of the article, then the exhaustion doctrine would be a dead letter.

8. Exhaustion issues are important and frequently litigated. Since this petition's filing, the Federal Circuit has

decided two more cases involving exhaustion arguments. *See Fuji Photo Film Co. v. ITC*, 474 F.3d 1281 (Fed. Cir. Jan. 11, 2007); *RFR Indus. v. Century Steps, Inc.*, Nos. 2005-1610, 2006-1285, 2007 U.S. App. LEXIS 3382 (Fed. Cir. Feb. 16, 2007). Respondent concedes the "prevalence of licensing restrictions in the marketplace" in the one area (software) where "license" restrictions on sold goods are consistent with this Court's cases. Opp. 16. (It notably does not acknowledge or respond to the petition's explanation of why software is unique.) The only reason such restrictions have not spread more widely through the economy yet is the common understanding, rooted in a century of this Court's case law, that chattels cannot be sold with "notices," backed up by threat of infringement suits, purporting to restrict their use or resale. Until now the *Mallinckrodt* line of cases has been thought to apply only to "enforceable contractual restrictions," which limited the opportunity for strategic behavior by patentees. But patent trolls will not miss this opportunity now. The prevalence of licensing restrictions in the software context also makes it clear that the wider business community will impose use and resale restrictions on sold physical goods now that the Federal Circuit has held that the same rules apply.

This is a straightforward legal question turning on the proper interpretation of this Court's cases, on which no further percolation is possible, with the potential to wreak havoc on the efficient transfer of technology, and involving billions of dollars in controversy in this case alone. The interlocutory posture is no reason to defer review. The Federal Circuit has decided the issue of national importance, and Respondent concedes that exhaustion would resolve all claims under 4 of the 5 patents. An interlocutory posture is "no impediment to certiorari where the opinion of the court below has decided an important issue, otherwise worthy of review, and Supreme Court intervention may . . . hasten or finally resolve the litigation." Stern, *supra* n.1, at § 4.18.

CONCLUSION

The petition for certiorari should be granted.

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